United States Court of Appeals

for the Second Circuit

PETITION FOR REHEARING

75-4227

United States Court of Appeals

FOR THE SECOND CIRCUIT

EDWIN C. WHITEHEAD and
JOSEPHINE WHITEHEAD,

Appellants,

—against—

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

ON APPEAL FROM THE UNITED STATES
TAX COURT

PETITION FOR REHEARING

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PETITION FOR REHEARING

PRELIMINARY STATEMENT

Appellants Whitehead petition this Court for rehearing of its per curiam affirmance on April 14, 1976, of the Tax Court's determination of their federal income tax deficiency. This Court's affirmance was based on the opinion of the Tax Court which is reported at 64 T.C. 78. Appellants do not dispute the underlying findings of fact reported in the Tax Court's opinion. However, based on those facts and on the other undisputed facts in this case there is no theory of the statute, regulations, or decisions of this Court upon which the conclusion of the Tax Court can be justified. The Tax Court's conclusion that Ininco was a controlled foreign corporation is, therefore, clearly erroneous.

The discussion which follows analyzes the portion of the Tax Court's opinion relating to the question of whether Ininco was a controlled foreign corporation. That determination depends on whether the United States common shareholder owned more than 50 percent of the voting power of all classes of stock of Ininco. Where, as here, the common shareholder and preferred shareholder each owned exactly 50 percent of the voting power, this Court has held that it is appropriate to determine whether the voting power of the preferred shareholder is "real and meaningful." The Tax Court in this case did not properly resolve that question.

Although Judge Wiles' opinion quotes the Treasury regulations, the opinion does not rely on them for its conclusion.* Rather, the opinion rests on an attempt to fit the case at bar into the mold set forth by this Court in its opinions in Kraus v. Commissioner, 490 F.2d 898 (2d Cir. 1974), and Garlock, Inc. v. Commissioner, 484 F.2d 197 (2d Cir. 1973), cert. denied 417 U.S. 911 (1974). However, the Tax Court clearly erred in its application to this case of the factors of "real and meaningful" voting power, as propounded

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* The Tax Court recognized that the facts in this case did not fit the 3-pronged test of Treasury Reg.§1.957-1(b)(2). Nevertheless, the government argued on brief and during oral argument that the 3-pronged test of the regulations applies. However, the record in this case clearly shows that none of the three tests has been met.

in Kraus, supra, and Garlock, supra. A careful analysis of the Tax Court's opinion establishes that its conclusion that Ininco is a controlled foreign corporation is not supportable upon any proper theory. Indeed, the Tax Court's conclusion is, at best, based upon a wholly improper legal standard of economic control.

ARGUMENT

The following is a paragraph by paragraph discussion and analysis of the Tax Court's opinion on the issue of whether Ininco was a controlled foreign corporation. Tracing through the six points relied on by the Tax Court establishes that the Tax Court was not warranted in concluding that Ininco was a controlled foreign corporation and, therefore, its decision is clearly erroneous. Commissioner v. Duberstein, 363 U.S. 278 (1960).

1. In support of its conclusion, the Tax Court first states that Romney, as a preferred shareholder, had a "limited stake" in Ininco's business, since it could only receive the amount of its investment on a sale or liquidation. However, it is the very nature of a preferred stock interest to provide a fixed interest in the assets of a corporation. This in no way detracts from the preferred shareholder's real and meaningful voting power.

The Tax Court then follows up on the "limited stake" argument, asserting that even though both the common

and preferred shareholders were subject to the identical requirement that their interest in Ininco be offered first to the remaining shareholder, as a practical matter the Articles of Association and the shareholders' agreement ensured that Romney had no real interest in disturbing control of Ininco since it could only obtain a return of its investment. The Tax Court reasons that if Romney wished to buy out the common stock interest it would have been required to pay whatever profits had been accumulated in Ininco and even if it wished to pay this amount, Romney lacked incentive since the business of Ininco was dependent on a continued supply of the product line, which was controlled by Appellants.

In the first instance, the Tax Court overlooks the fact that under the shareholders' agreement Romney had the right to purchase the common shareholder's interest at a price which was 40 percent less than the net asset value of Ininco, since under that agreement the purchase price took into account the reduction caused by the 40 percent U.K. levy. Having purchased at a discount, Romney would have been in a position of having a leveraged investment. More importantly, the Tax Court failed to consider that the common shareholder had an equally compelling reason not to disturb the equal division of control of Ininco between itself and the preferred shareholder; such a distrubance would have forfeited the U.K. income tax deferral for which Ininco qualified.

In any event, the fact that Romney's preferred stock interest gave it a fixed stake in Ininco does not mean that Romney did not have real and meaningful voting power. Romney had an investment in Ininco and its voting power was designed to help it protect that investment.

2. The Tax Court states that a second factor which indicates that Appellants had control over Ininco was their complete control over the product line. As this Court pointed out during oral argument of this case, since Ininco had a large amount of accumulated earnings, Romney's investment was secure for many years to come. Therefore, Romney did not need control over the product line, but only control over the disposition of accumulated earnings. Thus, Appellants' control over the product line also has no bearing on the question of whether Romney had real and meaningful voting power in Ininco. The Tax Court observed that the shareholder's agreement gave Romney no rights with respect to the product line after dissolution. Once again, as this Court pointed out, Romney was interested in the accumulated earnings which secured its investment and not the product line itself.

The Tax Court goes on to say that control by the 50 percent shareholder over the product line becomes a significant factor where such a situation exists in conjunction with other factors indicating that dominion and

control are possessed by the U.S. shareholders. However, the Tax Court does not state what these "other factors" are in this case. The simple truth is that Appellants' control over the product line in no way denied Romney real and meaningful voting power in Ininco or detracted from its 50 percent voting power.

3. The Tax Court next discusses the fact that Ininco was set up as a "deadlock" company and states that this Court in Garlock viewed the presence of an arbitration provision to be an unrealistic business solution. The Tax Court misses the point here entirely. In Garlock arbitration was necessary for the preferred sharholder to secure equality in voting power, while here, the preferred shareholder at all times has equality in voting power. Regardless of the arbitration clause, the presence of the arbitration provision in the case at bar does not reflect one way or the other on the question of real and meaningful voting power.

The Tax Court argues that a deadlock could be solved by Appellants merely terminating Ininco as seller of the product line. However, as this Court pointed out during oral argument, withdrawal of the product line would not affect a deadlock since Romney could sit back and collect its dividends for years to come.

4. The Tax Court then states that "it defies credulity that Romney would have advanced more money" than the common shareholder for a twelve and a half percent dividend of a company that was to be exempt from U.K. taxes if it truly obtained 50 percent of the voting power of that company. As this Court pointed out during oral argument, there was no assurance that Ininco would be a successful company and, in fact, it could have suffered losses; therefore, any test which calls for a hindsight comparison of voting power with economic value should not be used. Romney's capital contribution upon Ininco's incorporation was slightly more than the common shareholder's contribution. In exchange, Romney obtained 50 percent of the voting power and a preference as to dividends and capital. This hardly "defies credulity" and does not adversely reflect on whether Romney had real and meaningful voting power.

5. The Tax Court then points to the manner in which Ininco was terminated as showing the control of Appellants. The Tax Court fails to realize that Romney had an alternative to selling its interest to the buyer which Appellants had located; Romney's board knew it could have been difficult, but it decided not to offer an impediment to the sale. It could have forced

a liquidation of Ininco which would have triggered the 40 percent tax, or, alternatively, it could have chosen to do nothing and collect its dividends year after year. If the common shareholder had offered to sell its shares, Romney had the right to purchase them at a 40 percent discount from net asset value, thereby enabling it to leverage its investment.

The Tax Court states that "petitioners contend that Romney agreed to sell its interest in Ininco only after being promised and receiving a premium..." That is not merely a contention, rather it is a fact supported by the testimony of Romney's Managing Director (App. 113A-114A) and is referred to in the corporate minutes of Ininco (Ex. 26-Z, App. 222A) and in a letter from Romney's Managing Director set forth at page 231A of the Appendix.

6. Finally the Tax Court points to an examination of the overall transaction in support of its determination that Appellants "retained" dominion and control over Ininco, asserting that Ininco was created to serve Appellants' purpose and that Romney was powerless to alter the course of events. Appellants do not deny that Ininco served Appellants' purpose, but the Tax Court fails to recognize that Ininco also served Romney's purposes and that Romney would not have

made the investment if it did not receive equal voting power. Further, the Tax Court's assertion that Romney was powerless to alter the course of events is not justified. The Tax Court states that Romney was "in a position only to force liquidation of Ininco." However, as this Court observed, that is not correct; Romney had the very real power to force a deadlock and sit back and collect its dividends.

CONCLUSION

The above discussion has traced through, paragraph by paragraph, the Tax Court's opinion. The facts in this case do not support the Tax Court's legal conclusion that Ininco was a controlled foreign corporation. Rather, its conclusion is based upon speculation and inference upon inference. Indeed, the facts in this case support the opposite conclusion and the opinion of the Tax Court is, therefore, clearly erroneous.

It is respectfully requested that the Court reconsider its decision in this case and reverse the decision of the Tax Court.

Respectfully submitted,

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v.	)	No. 75-4227
COMMISSIONER OF INTERNAL REVENUE, Appellee	)	

CERTIFICATE OF SERVICE

It is hereby certified that service of the Petition for Rehearing in the above-entitled case has been made on counsel for the Appellee on this 28th day of April, 1976, by mailing two copies thereof in an envelope, with postage prepaid, addressed to Scott P. Crampton, Assistant Attorney General, Tax Division, United States Department of Justice, Washington, D.C. 20530, attention Jeffrey S. Blum, Esq.

Dated: April 28, 1976

Lary S. Wolf

Lary S. Wolf

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